

ICPS newsletter

The reasons behind the re-monetisation of the economy in Ukraine

The current trend in Ukraine's economy is re-monetisation; under an expansive monetary policy, inflation in Ukraine has stayed low and even declined. For two years now, most experts have tended to underrate the economy's ability to swallow an increase of the money supply without inflation. During the roundtable on the "Impact of Monetary Aggregate Developments on Inflationary Processes in Ukraine over 2001–2002", held at the International Centre for Policy Studies last week, Ruslan Piontkivsky, ICPS senior economist, presented an analysis of the causes and duration of the re-monetisation phenomenon in the Ukrainian economy

Over the last three years, the National Bank of Ukraine has pursued an expansive monetary policy, with the following results:

- Monetary aggregate growth over 1999–2001 approximated 40% annually;
- The NBU loosened its obligatory reserve requirements on deposits, from 15% at the beginning of 2000 to 0–14% currently;
- The NBU curtailed the discount rate from 27% at the beginning of 2000 to 10% currently.

An expansive monetary policy is usually aimed at galvanising economic activity and, consequently, at boosting the GDP. Simultaneously, according to theory, such a policy may trigger overall price growth (inflation). In Ukraine, inflation has continued falling (in 2000, inflation constituted 25.8 %, while in 2001 it was 6.1%).

Factors influencing the inflation rate could be divided into two principal groups—non-

monetary and monetary ones. Non-monetary factors can include the following:

- Administratively regulated price formation. For example, tariffs for specific services, particularly utility services, are still state-regulated. Maintaining a certain tariff level keeps in check the overall price growth in the economy;
- International prices on basic goods. For example, overall prices in Ukraine are affected by global prices for fuel. Recently, oil prices have gone down in international markets, which, in turn, prompted the inflation rate to decline a little across the country;
- Harvest yields in the agricultural sector. Consumer goods within Ukraine are mostly contributed by the agricultural sector. In the wake of the 2001 harvest, the supply of agricultural produce in the domestic market increased, with prices for certain goods decreasing.

Despite the importance of the above factors

- money velocity, that is, the higher the velocity, the smaller the demand for money;
- price levels (inflation); increasing price levels in the economy lead to a decreasing real demand for money.

Therefore, if monetary aggregates increase (higher money supply), inflation may stay moderate, in case the country's GDP is growing or the velocity is declining.

We can emphasise the following re-monetisation factors in Ukraine's economy:

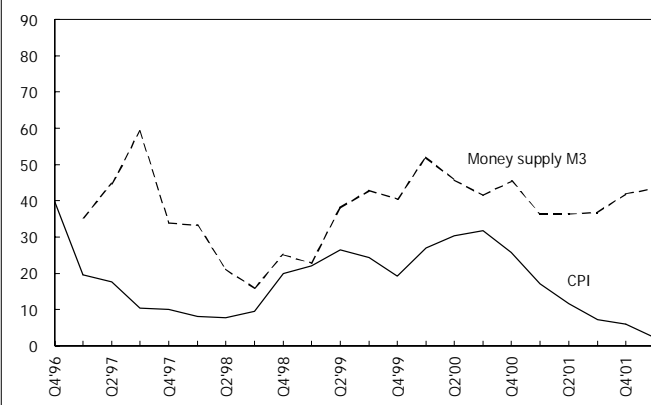
- Declined opportunity cost of money (loan interest rate, interest rate margin, inflation); therefore, economic agents keep more assets in the form of currency;
- Increased share of cash payments in industry, which boosts real demand for money; the share of cash settlements rose by 44 percentage points over three years;
- Relatively decreased volumes of accounts receivable and payable (as a share of GDP);
- More robust currency exchange rate, resulting in a decreased demand for foreign currency in favour of the national currency.

The strengthened hryvnia-to-dollar exchange rate boosted public confidence in the national currency. Therefore, we are currently witnessing the so-called de-dollarisation of bank credits and deposits in Ukraine, as well as currency de-dollarisation. The share of deposits in foreign currency dropped from 44.6% in January 2000 to 32.2% in December 2001, while the share of dollar loans fell from 51.5% to 44.5%. The currency de-dollarisation is corroborated by the fact that during 2001–2001, the Ukrainian population officially sold 188.5 million more US dollars than it purchased.

The estimated empirical "error correction" model leads to the following conclusions:

- Real demand for the hryvnia is positively influenced by the real GDP increase, and negatively affected by an increased exchange rate and inflation;
- In case of an abrupt change of indicators (GDP, exchange rate, inflation), 90% of the shock adjustment takes half a year, then demand for money stabilises in the long-term dynamics;

Developments of the monetary aggregate M3 and the consumer inflation in Ukraine
(percentage change over past four quarters)



and the need to scrutinise them, the round-table discussion focused on an analysis of the monetary factors of the low inflation rate.

As the quantity money theory goes, demand for money is governed by the following factors:

- the country's GDP, with GDP growth triggering higher money demand;

• The biggest effect was produced by changing or accelerating trends (higher GDP growth, slower inflation rate, shift to strengthening of the nominal exchange rate); all this took place in 2001;

• This year, we should not expect a higher growth rate of real demand for money than in 2001.■

For further information, please contact Ruslan Piontkivsky at tel.: (38-044) 463-5966, or e-mail: rpiontkivsky@icps.kiev.ua.

The materials of the presentation on the "Impact of Monetary Aggregate Developments on Inflationary Processes in Ukraine over 2001–2002" are posted on the ICPS web-site: www.icps.kiev.ua/docs/other/pres020423.ppt.

NGOs collaborate to evaluate the impact of EU enlargement and develop policy recommendations

European Union enlargement will affect current EU member states as well as those who will be joining, and of course it will impact on the bilateral relations between neighbouring countries. Therefore, it is important to (1) systematise the perception of the government and the public opinion on the enlargement and implementation of Schengen rules in all affected states; and (2) identify bilateral and specific regional problems that may appear as a consequence of EU enlargement and implementation of the Schengen regime. In order to fulfil the two objectives, ICPS' colleagues from the Institute of Public Affairs (Warsaw) initiated and launched a project on the "Impact of EU Enlargement and Implementation of Schengen in the CEE Region"

The project "Impact of EU Enlargement and Implementation of Schengen in the CEE Region" was open to the participation of all interested policy think tanks in the Open Society Institute (OSI) network. Currently, the research project involves experts from think tanks of the accession countries. Ukrainian and Moldovan experts were also invited, as representatives of countries that will be affected by the enlargement. ICPS is responsible for the Ukrainian part of the research.

It is expected that this collaborative research on the consequences of Schengen expansion will result in policy recommendations on minimising the negative impact. The research generated will contribute to necessary dialogue on the effects of EU enlargement in the participating countries.

The inclusion of Ukrainian experts in the discussion and policy formulation on EU enlargement is of particular importance, as Ukrainian experts will have a voice on issues that vitally affect their country.

The project entails the following stages:

- Conducting public discussions on the consequences of EU enlargement, enabling Ukrainian society to prepare for changes;
- The preparation of three policy papers by Ukrainian experts on the consequences of EU enlargement;

- Developing policy recommendations on how to minimise the negative consequences of enlargement;

- Holding expert discussions of the Ukrainian policy papers with representatives of Central and Eastern European think tanks;

- A presentation in Brussels on the policy recommendations generated by the project.

Currently, ICPS is in the process of developing policy recommendations based on policy papers already produced and discussed. Policy recommendations from all participating countries will be gathered into one policy document and presented during the conference in Brussels.

We expect the following project outcomes:

- Research conclusions on the consequences of EU enlargement will be introduced into the Ukrainian policy discourse, increasing the quality of government decisions;
- Ukrainian government and non-government experts collaborate with experts from neighbour countries;
- Ukrainian experts have access to information on how Schengen enlargement is viewed by Ukraine's neighbours—Poland, Slovakia, Czech Republic, Hungary, Moldova, Romania;
- Ukrainian analysts are empowered through collaboration with Central and Eastern European think tanks.

The cooperation between ICPS and IPA has lasted for almost two years. Our joint activities covered both the organization of seminars, conferences and workshops, where Polish and Ukrainian experts could exchange their expertise, as well as policy research projects that enabled both think tanks to develop policy recommendations applicable for the two countries.

Projects initiated by ICPS aimed to study Polish experience in institutional reform implementation in the context of European integration, and to use this experience in Ukraine. Projects initiated by IPA aimed to study the consequences of EU enlargement and to develop policy recommendations for minimisation of the negative impact.

The ongoing cooperation between Ukrainian and Polish think tanks proves that the Open Society Institute network helps NGOs from different countries to implement joint initiatives and to exchange their policy expertise and experience. Development of bilateral relations between think tanks in the framework of the OSI network, instead of cooperating on an *ad hoc* basis, both strengthens the network and enables think tanks. In this regard, ICPS is currently cooperating with Czech, Slovak, and Romanian policy think tanks on the development of joint projects.

Areas of key importance are the following:

- Consequences of EU enlargement;
- Institutionalisation of the Partnership and Cooperation Agreement (PCA) implementation;
- Institutionalisation of wider support of the integration process;
- Exchange of experts or secondment of staff to CEE think tanks.■

For further information, please contact Olha Shumylo, tel. (38-044) 463-5967, e-mail: oshumylo@icps.kiev.ua.

The next issue of ICPS Newsletter will be published on 13 May, 2002.

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies delivered by electronic mail.

To be included in the distribution list mail to: marketing@icps.kiev.ua.

ICPS Newsletter is published by the ICPS Publications Group.

ICPS Newsletter editor Maksym Mashliakivsky (mmax@icps.kiev.ua).

English text editor D. (Ksenia) Ovcharenko. Articles may be reprinted with ICPS consent.

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